

Testimony of Sarah Anderson Global Economy Project Director Institute for Policy Studies

Before the Committee on Budget United States Senate

"Assessing Inequality, Mobility, and Opportunity"

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I would like to thank Chairman Conrad, Ranking Member Sessions, and the other members of the Committee for inviting me to contribute to this discussion. I believe inequality is the pressing issue of our time, and I applaud the committee for giving our nation's grand divide this level of attention.

Let me begin with the good news. Our nation has tackled this problem before — and successfully so. A century ago, during the original "Gilded Age," we experienced extremely high levels of inequality, levels comparable to those we are seeing today. Over the span of several decades, policymakers, backed by strong labor unions and other social movements, turned that inequality around. Through fair taxation and effective social programs and standards, we had achieved much lower levels of inequality by the middle of the twentieth century. We had laid the foundation for a strong and stable economy and put in place a middle class that was broader than any the world had ever seen. There is much to learn from that experience.

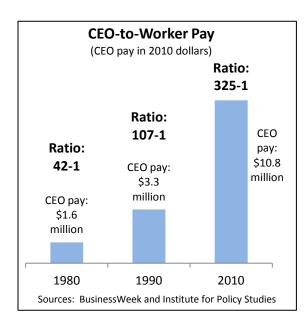
Executive compensation as a key driver of inequality

The Institute for Policy Studies has particular expertise in one aspect of our nation's drift into deep and extreme inequality: executive compensation.

For nearly 20 years, we at IPS have been publishing an annual analysis of the upward spiral in CEO pay. Our *Executive Excess* series has helped track and explain this trend, which has contributed significantly to the rising share of national income that flows to our nation's top 1 percent. Increases in executive compensation do not tell the whole story behind our growing economic divide, but they do offer an important lens into the broader problem.

Some select indicators of just how disproportionately large rewards for executives have become:

 The ratio between CEO and worker pay has risen from 42-to-1 in 1980 to 107-to-1 in 1990 to 325to-1 in 2010.¹



- Average compensation for S&P 500 CEOs reached \$10.8 million in 2010, more than six times the level for large company CEOs in 1980, after taking inflation into account, and triple the level in 1990.²
- Executives and financial professionals account for 70 percent of the increase in the share of national income going to the top 0.1 percent between 1979 and 2005.³
- Combined compensation for the top five executives by corporate enterprise increased as an average percentage of corporate profits from 5 percent in the period 1993-1995 to nearly 10 percent in the period 2001-2003.⁴

Why should policymakers be concerned about excessive executive compensation?

1. Excessive compensation encourages executive behavior that harms the broader economy

Over nearly two decades, my colleagues and I at the Institute for Policy Studies have examined how extremely high levels of compensation affect executive behavior. Such massive jackpots, we've found, give executives incentives to behave in ways that may boost short-term profits and expand their own paychecks at the expense of our nation's long-term economic health.

Among our research findings:

- In last year's annual *Executive Excess* report, we looked at the intersection between executive compensation and tax dodging. We found that among the top 100 highest-paid CEOs in 2010, 25 had made more in personal compensation than their companies had paid in federal income taxes.⁵
- In 2010, we found that CEOs of the 50 firms that had laid off the most workers since the onset of the economic crisis had made nearly \$12 million on average, 42 percent more than the CEO pay average at S&P 500 firms as a whole. 6
- In 2009, we found that the top five executives at the 20 banks that had accepted the most federal bailout dollars had averaged \$32 million each in personal compensation during the three years leading up to the 2008 meltdown.⁷
- In 2004, we found that CEOs at companies which had outsourced the most U.S. jobs to other countries were rewarded with bigger paychecks than their peers. Average CEO compensation at the 50 firms that had outsourced the most service jobs increased by 46 percent in 2003, compared to a 9 percent average increase for all large company CEOs. Top outsourcers earned an average of \$10.4 million, 28 percent more than the average CEO compensation of \$8.1 million.⁸
- In 2002, we found that top executives at 23 companies under government investigation for their accounting practices had earned far more during the preceding three years than average CEOs. CEOs at the firms under investigation had earned an average of \$60.1 million during 1999-2001, 65 percent more than the average of \$36.5 million for all leading executives for that period.⁹

Tax dodging, mass layoffs, reckless financial deals, offshoring jobs, "creative accounting"—all of these appear to boost CEO pay. But they have dealt one body blow after another to the American middle class, leaving a deeply skewed distribution of income and wealth.

2. Extreme CEO-worker pay gaps undermine business enterprise effectiveness

Our nation's long-term economic health depends to a great extent on the effectiveness of our U.S. enterprises. A growing body of research indicates that extreme inequality within firms leaves enterprises less productive and effective.

A Stanford University review of several studies found that organizations with highly differentiated pay between top and bottom earners tended to experience a decline in employee morale and job satisfaction. Another study showed that in corporations with relatively narrow pay gaps, employees tended to produce higher quality products. Additional research indicates that wide pay gaps lead to higher employee turnover rates.

John Mackey, CEO of Whole Foods, limits his cash compensation to no more than 19 times the average for workers at his firm. In the *Harvard Business Review*, he wrote "Because of the yawning gap between the leaders and the led, employee morale is suffering, talented performers' loyalty is evaporating, and strategy and execution is suffering at American companies." ¹³

Peter Drucker, the father of modern management theory, pointed out in the early 1980s that in any hierarchy, every level of bureaucracy must be compensated at a higher rate than the level below. The more levels, the higher the pay at the top. This gives CEOs a personal interest in maintaining rigid hierarchies that are disempowering for workers. Drucker's solution was to limit executive pay to no more than 20 times the compensation of their employees. A landmark Brookings Institution report by David Levine supported this general view, stating "large differences in status can inhibit participation."

Jim Collins, the author of several best-selling books on management science, spent five years trying to determine "what it takes" to turn an average company into a "great" one. He eventually identified 11 firms that had successfully generated off-the-charts stock returns over 15 years. Not a single one had a high-paid CEO. A celebrity CEO, Collins wrote, turns a company into "one genius with 1,000 helpers." ¹⁶

Recent reforms to address excessive executive compensation

Executive pay is not just an issue for shareholders. As the Wall Street meltdown made vividly clear, excessive pay packages contribute to a reckless corporate culture that endangers the well-being of the broader public. Responsible action is needed to encourage more rational pay practices.

Dodd-Frank Pay Reforms: In the wake of the 2008 crash, Congress did include a number of modest executive compensation provisions in the Dodd-Frank financial reform bill. One of the most innovative of these provisions, Section 953b, requires all U.S. corporations to compute and report the ratio between CEO and median employee pay. This disclosure requirement will improve information available for shareholders and the public on a metric fundamental to enterprise success. Hopefully, it will also encourage corporate boards to narrow this gap by raising median worker pay and/or reducing pay at the top.¹⁷

However, in the face of an intense backlash from corporate lobby groups, the SEC has delayed implementation of this new law. Regulators are facing strong pressure to water down several additional Dodd-Frank pay provisions, including Section 956, which would give regulators the power to prohibit pay packages for financial executives that encourage inappropriate risks.

Limits on the Tax Deductibility of Executive Pay: Congress also set an important precedent in the Troubled Asset Relief Program by establishing a \$500,000 cap on the tax deductibility of executive

compensation at bailout firms. A similar provision was included in the 2010 health care reform legislation with regard to health insurance companies. These provisions took an important step towards filling a loophole in the tax code that encourages excessive pay.

Currently, there are no meaningful limits on how much corporations can deduct from their taxes for the expense of executive compensation. The more they pay their CEO, the more they can deduct from their taxes. Other taxpayers bear the brunt of this loophole, either through the increased taxes needed to fill the revenue gaps or through cutbacks in public spending. A tax deductibility cap on executive compensation should be established for all corporations. Ideally, it would deny all firms tax deductions on any executive pay that runs over 25 times the pay of a firm's lowest-paid employee or \$500,000, whichever is higher.

A broader agenda to reverse extreme inequality

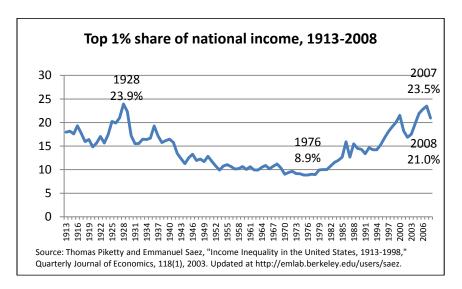
While Congress has made some small steps forward in recent years, much more needs to be done to rein in executive pay, as part of a broader effort to reverse extreme inequality. This broad agenda will need to include initiatives to lift up the bottom through living wages and more accessible high-quality health care and education, as well as efforts to address corporate concentration, campaign finance laws, and other obstacles to shared prosperity. But a look back at the previous era's efforts to tackle inequality reveals that one of those reformers most important tools was progressive taxation.

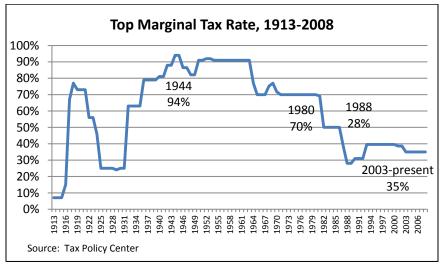
In the middle of the last century, the U.S. tax system did a great deal to offset maldistributions of income and wealth. A major reason corporate boards did not compensate executives at such exorbitant levels during that period was that the bulk of that excessive pay would have simply been taxed away.

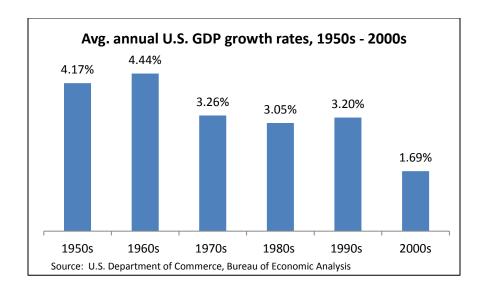
During the 1950s and early 1960s, the top marginal tax rate on income over \$400,000 a year (the equivalent of less than \$3 million today) faced a tax rate just over 90 percent. During that time, the share of the nation's total pre-tax income going to the top 1% hovered around 10 percent, according to one academic study. As taxes on the wealthy have declined over the past 50 years, we've seen a steady increase in wealth and income concentration at the top. Today, with a top marginal rate of only 35 percent, the top 1% enjoy more than 20 percent of the nation's income. Not only did the "high-tax" decades coincide with lower inequality rates, they were also marked by relatively high GDP growth rates. (See details in charts on following page).

A recent report by the Congressional Budget Office found similar trends towards rising inequality in after-tax income during the period 1979-2007. According to their calculations, the top 1 percent of the population with the highest income saw an increase in their average real after-tax household income of 275 percent during this period, compared to only 65 percent for the rest of the highest quintile (the 81st through 99th percentiles); 37 percent for the population in the middle of the income scale (the 21st through 80th percentiles); and 18 percent for the lowest quintile.²⁰

Preferential treatment and loopholes have allowed the richest Americans to pay far less than the statutory tax rates. The richest 400 U.S. taxpayers have seen their effective tax rate decline from over 40 percent of their income in 1961 to just 18.1 percent in 2010.²¹ In 2009, the most recent data available, 1,500 millionaires paid no income taxes, largely because they made use of off-shore tax schemes, according to the Internal Revenue Service.²²







Key elements of tax reform to reverse extreme inequality

This section draws heavily from the forthcoming book by my Institute for Policy Studies colleague Chuck Collins, 99 to 1: How Wealth Inequality is Wrecking the World and What We Can Do About It (Berrett-Koehler, March 2012).

New income tax brackets for the 1 percent. Under our current tax rate structure, households with incomes over \$350,000 pay the same top income tax rate as households with incomes over \$10 million. In the 1950s, there were 16 additional tax rates over the highest rate (35 percent) that we have today.

A tax on financial speculation. The richest 1 percent of Americans contributed to the 2008 economic meltdown by moving vast amounts of wealth into the speculative shadow banking system. Our society is still paying the mammoth social costs of this meltdown — through home foreclosures, unemployment, and the destruction of personal savings. A modest federal tax on every transaction that involves the buying and selling of stocks and other financial products would both generate substantial revenue and dampen short-term speculation. For ordinary investors, the cost would be negligible. A financial speculation tax would amount to a tiny insurance fee to protect against financial instability.

A higher tax rate on income from wealth. Giving tax advantages to income from wealth also encourages short-term speculation. With carefully structured rate reform, we can end this preferential treatment for capital gains and dividends and, as Warren Buffett and other analysts have noted, encourage long-term investing.

A progressive estate tax on the fortunes of the 1 percent. The wealthiest Americans have all benefited from generations of investments in pubic goods that have left the United States with an infrastructure — in everything from education and roads to dispute resolution — that enables wealth creation. Our wealthy have a responsibility to give back to the society that has given them so much. The current estate tax on inherited wealth stands at 35 percent and only applies to estates over \$5 million (\$10 million for a couple). Congress could raise additional revenue from those with the greatest capacity to pay by establishing a progressive estate tax with graduated rates and a 10 percent surtax on the value of an estate above \$500 million, or \$1 billion for a couple.

An end to tax haven abuse. By one estimate, the use of tax havens by corporations and wealthy individuals costs the federal treasury \$100 billion a year. These havens are transferring wealth out of local communities into the foreign bank accounts of the world's wealthiest and most powerful. Havens, or more accurately "secrecy jurisdictions," can also facilitate criminal activity, from drug money laundering to the financing of terrorist networks.

A wealth tax on the top 1 percent. A "net worth tax" could be levied on household assets, including real estate, cash, investment funds, savings in insurance and pension plans, and personal trusts. Such a tax could be calibrated to tax wealth only above a certain threshold. For example, France's solidarity tax on wealth only kicks in on asset value in excess of \$1.1 million.

The elimination on the cap on social security withholding taxes. Extending the payroll tax to cover all wages, not just wage income up to \$110,100, would be an important step. Some of our richest Americans are done paying withholding taxes in January, while ordinary working people pay all year.

Conclusion

Our current levels of extreme inequality did not suddenly appear. They have grown steadily over the past 30 years. Reversing this inequality trend will be a long-term challenge. But we have transformed a highly divided nation into a more stable and equitable society before. We can certainly do it again.

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¹⁴ Peter F. Drucker, *The Changing World of the Executive*. New York: Times Books, 1982, p. 22.

¹⁵ David I. Levine, *Reinventing the workplace: how business and employees can both win.* Brookings Institution Press, April 1, 1995, p. 53.

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¹⁷ See: Institute for Policy Studies Comments to the SEC on Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, March 16, 2011. Available at: http://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-62.pdf

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¹ Figures from 1980 and 1990 are from *BusinessWeek*, April 26, 1993. Figure for 2010 is from Sarah Anderson, Chuck Collins, Scott Klinger, Sam Pizzigati, "Executive Excess 2011: The Massive CEO Rewards for Tax Dodging," Institute for Policy

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